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Lender Liability: Evaluating, Minimizing and Defending Claims

Defending Against Attacks on Loans in Workouts, Defaults, and Bankruptcy

TUESDAY, DECEMBER 21, 2010

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Seven Rivera, Partner, **Chadbourne & Parke**, New York

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COMMERCIAL LENDER LIABILITY IN 2011

DECEMBER 21, 2010

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FACULTY

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His practice involves all aspects of bankruptcy and restructuring representing both secured and unsecured lenders, creditors, debtors and creditor committees in complex and high-profile Chapter 11 cases. He also represents buyers and sellers in sales and other asset dispositions both in and outside formal reorganization proceedings and provides bankruptcy advice concerning corporate transactions.

PROGRAM

Part 1: Loan Defaults and Loan Workouts
By Thomas J. Hall and Thomas J. McCormack

Part 2: Lender Liability Claims in Bankruptcy
By Seven Rivera

Part 3: Q & A: 15 minutes

PART 1:

LOAN DEFAULTS AND LOAN WORKOUTS

THE SWINGING PENDULUM

Wells Fargo v. Tyson, 27 Misc. 3d 684, 692, 897 N.Y.S.2d 610, 617 (Suffolk Co. 2010).

- "[P]laintiff willfully took it upon itself to enter the property on more than one occasion, doing so unreasonably and without notice, in direct contravention of the terms of its mortgage promulgated to defendant by its assignor."

- "This is even more distressing when it is considered that plaintiff breached its obligations to defendant under the mortgage, ***running roughshod over defendant's rights with a specious claim*** that it is acting to protect its rights and the property. In short, the conduct of plaintiff was ***nothing short of oppressive and would best be described as heavy-handed and egregious***, to say the very least."

- Court awarded ***$150,000 in punitive damages*** "as an appropriate deterrent to any future ***outrageous, improper and unlawful deeds***."

Emigrant Mtge. Co. v. Corcione, 28 Misc. 3d 161, 168-69, 900 N.Y.S.2d 608, 613 (Suffolk Co. 2010).

"In short, the conduct of plaintiff in this matter has been ***overreaching, shocking, willful and unconscionable***, is wholly devoid of even so much as a scintilla of good faith and cannot be countenanced by this court."

In re Tousa, Inc., Case No. 08-10928 (Bank. S.D. Fla.) (Transcript Jan. 9, 2009)

"Their nondiscussion of that payment in the papers is extraordinary and, frankly, their request now in light of that payment, smacks -- ***smacks of the kind of selfish financial excess which the entire country has been forced to confront*** in these last few months."

In re A.T. Reynolds & Sons, Inc., 424 B.R. 76, 95 (Bankr. S.D.N.Y. 2010).

- "Indeed, Wells Fargo and its counsel ***did everything they could to undermine, delay and impede the Mediation*** . . . Counsel to Wells Fargo allegedly threatened the Mediator that he would never mediate another matter to which Wells Fargo was a party . . . ."

- Wells Fargo sanctioned legal fees to be determined.

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Nosek v. Ameriquest Mortgage Co. (In re Nosek), 386 B.R. 374, 380-84 (Bankr. D. Mass. 2008) rev'd in part, 406 B.R. 434 (D. Mass. 2009) aff'd, 609 F.3d 6 (1st Cir. 2010).

- Original lender servicer ***sanctioned $250,000*** and lender's law firm ***sanctioned $25,000*** for apparent misrepresentations as to the status of the lender as the holder of a note and mortgage in debtor's bankruptcy action

- "Unfortunately the parties' confusion and lack of knowledge, or perhaps sloppiness, as to their roles is not unique in the residential mortgage industry. Nor are 'mistakes' and misrepresentations limited to the identification of roles played by various entities in this industry"

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& PARKE LLP

Nosek v. Ameriquest Mortgage Co. (In re Nosek), 386 B.R. 374, 380-84 (Bankr. D. Mass. 2008) rev'd in part, 406 B.R. 434 (D. Mass. 2009) aff'd, 609 F.3d 6 (1st Cir. 2010).

- "The Court has had to expend time and resources, as have debtors already burdened in their attempts to pay their mortgages, because of ***the carelessness*** of those in the residential mortgage industry and ***the bombast*** this Court and others have encountered when calling them on their shortcomings"

- "This Court will not countenance creditors and creditors's attorneys holding themselves to a different and clearly lower standard than what they expect of the Debtor. ***It will not tolerate a lender's or servicer's disregard for the rules that govern litigation***, including contested matters, in the federal courts. It is the *creditor's* responsibility to keep a borrower and the Court informed as to who owns the note and mortgage and is servicing the loan, not the borrower's or the Court's responsibility to ferret out the truth . . . ."

Nosek v. Ameriquest Mortgage Co. (In re Nosek), 386 B.R. 374, 380-84 (Bankr. D. Mass. 2008) rev'd in part, 406 B.R. 434 (D. Mass. 2009) aff'd, 609 F.3d 6 (1st Cir. 2010).

- "It is worth repeating as a warning to lenders and servicers that the rules of this Court apply to them. Their private agreements and the frenzied trading market for mortgages do not excuse compliance with the Bankruptcy Rules any more than they would justify ignoring the Bankruptcy Code."
- Lender sanction reduced on appeal to $5,000

*IndyMac Bank, F.S.B. v. Yano-Horoski, 26 Misc. 3d 717, 890 N.Y.S.2d 313 (Sup. Ct. Suffolk Co. 2009), rev'd, No. 2009-11392, 2010 N.Y. App. Div. LEXIS 8591, at *1 (2d Dep't Nov. 16, 2010)*

- Foreclosure judgment granted to lender. Court then granted borrower's request for settlement conference based on the "subprime" nature of loan.

- At conference, lender refused to allow a short-sale to borrower's daughter, a loan modification, defendant's husband and daughter assumption of debt, or a deed in lieu.

- Court noted bank's ***"opprobrious demeanor and condescending attitude."*** Court thereafter determined lender wrongly calculated the amount owed.

*IndyMac Bank, F.S.B. v. Yano-Horoski, 26 Misc. 3d 717, 890 N.Y.S.2d 313 (Sup. Ct. Suffolk Co. 2009), rev'd, No. 2009-11392, 2010 N.Y. App. Div. LEXIS 8591, at *1 (2d Dep't Nov. 16, 2010)*

Holding:

Court cancelled indebtedness, discharged mortgage, vacated the foreclosure judgment, and barred lender from ever collecting on the adjustable rate note.

- Court determined lender exhibited unclean hands and bad faith. Refused to resolve the controversy.

- Court found matter did not have to result in eviction (as compared to other cases) because of borrower's willingness to arrange restructured repayment.

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*IndyMac Bank, F.S.B. v. Yano-Horoski, 26 Misc. 3d 717, 890 N.Y.S.2d 313 (Sup. Ct. Suffolk Co. 2009), rev'd, No. 2009-11392, 2010 N.Y. App. Div. LEXIS 8591, at *1 (2d Dep't Nov. 16, 2010)*

- Court noted that society would benefit from restructuring because no neighborhood blight and a family would remain domiciled.

- Lender's actions were ***unconscionable, egregious and vexatious***; lender without recourse in a court of equity.

*IndyMac Bank, F.S.B. v. Yano-Horoski, 26 Misc. 3d 717, 890 N.Y.S.2d 313 (Sup. Ct. Suffolk Co. 2009), rev'd, No. 2009-11392, 2010 N.Y. App. Div. LEXIS 8591, at *1 (2d Dep't Nov. 16, 2010)*

Appellate Division:

Reversed and reinstated the note and mortgage. Severe sanction not authorized and lender was not given fair warning.

- Trial court erroneously relied equitable powers to cancel the mortgage and note.

- Equity does not relieve homeowner from contractual obligations, particularly after a judgment rendered.

TWO REALITIES OF LENDER LIABILITY:

1) Juries Like Borrowers, Not Lenders
2) Potential Damage Exposure Can Be Huge

SOUND LEGAL COUNSELING DURING DEFAULT AND WORKOUT STAGES CRITICAL TO AVOIDING LIABILITY EXPOSURE

IMPORTANCE OF LENDER DUE DILIGENCE

DDJ Mgmt., LLC v. Rhone Group LLC, 15 N.Y.3d 147 (2010)

- Four lenders loaned $40 million to a remanufacturer of automobile parts. The borrower later defaulted.

- Lenders filed suit for fraud against those who owned and controlled the borrower.

- Lenders alleged "that defendants presented [the lenders] with [borrower] financial statements that were false and misleading."

- The defendants filed motion to dismiss as lenders had "failed to make a reasonable inquiry into the truth of what defendants said [in the borrower's financial statements]" and therefore could not have reasonably relied.

DDJ Mgmt., LLC v. Rhone Group LLC, 15 N.Y.3d 147 (2010)

- Trial court refused to dismiss fraud claim.

- Appellate Division dismissed the fraud claim because the lenders could not "properly allege reasonable reliance on the purported misrepresentations [in the borrower's financial statements]" as they "never looked at [the borrower's] books and records." *DDJ Mgmt., LLC v. Rhone Group LLC*, 60 A.D.3d 421, 424, 875 N.Y.S.2d 17, 19 (1st Dep't 2009).

- Court of Appeals (highest court) reversed.

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DDJ Mgmt., LLC v. Rhone Group LLC, 15 N.Y.3d 147 (2010)

- The Court held that a jury could find that the lenders were justified in relying on the financial statements because they had "made a significant effort to protect themselves against the possibility of false financial statements." The lenders had insisted that the borrower make specific, written representations and warranties in the loan agreement.

- Acknowledged that "there were hints from which [the lenders] might have been put on their guard in this transaction."

- Court "decline[d] to hold as a matter of law that [the lenders] were required to do more — either to conduct their own audit or to subject the preparers of the financial statements to detailed questioning."

DDJ Mgmt., LLC v. Rhone Group LLC, 15 N.Y.3d 147 (2010)

- Court of Appeals decision only concerned the sufficiency of the complaint. Ultimate reasonableness of the lenders' reliance in the face of their failure to conduct due diligence is for trial.

The "Good Faith" Defense to Fraudulent Conveyance

" . . . a transferee or obligee of such a transfer or obligation that takes for ***value*** and in ***good faith*** has a lien on or may ***retain any interest transferred*** or may ***enforce any obligation incurred***, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation . . . "

11 U.S.C. § 548(c)

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

Held: Lenders performed inadequate diligence and acted in bad faith.

- "Citi nevertheless pressed on with the transaction. Its due diligence, however, failed to uncover the privately-held views of TOUSA's senior management, which were considerably more pessimistic than TOUSA's projections used to support the July 31 Transaction. For example, Citi never discovered the Strategic Alternatives memo."

- Due diligence cannot rely solely on financial statements and objective analysis, but must probe the subjective views of senior management and include a comprehensive review of internal documents.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

- "Several of the Senior Transeastern Lenders rested their good faith defense in part on the due diligence they believed had been conducted by Citi or the involvement of third-party professionals in the transaction. No representative of the Senior Transeastern Lenders—other than Burns (see below)—suggested that his organization performed its own due diligence."

- Individual lenders cannot rely solely on the diligence performed by other members of the lending syndicate, even the administrative agent's.

In re TOUSA, Inc., *422 B.R. 783 (Bankr. S.D. Fla. 2009)*

- "The Alix solvency opinion was a contingent fee arrangement: TOUSA agreed to pay $2 million if Alix ultimately opined that TOUSA would be solvent immediately following the July 31 Transaction; but if Alix could not so opine, TOUSA would pay Alix only its time charges and reimburse its costs."

- Lenders' reliance on third-party solvency opinions may be called into question if doubts can be raised about the third party's impartiality.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

- "According to one of the lead Citi bankers on the deal, the solvency opinion condition required an 'independent' firm because Citi did not want TOUSA to be able to influence the conclusion of the firm rendering the solvency opinion. But in rendering its opinion, Alix in fact relied heavily (if not exclusively) on the assumptions and projections provided by TOUSA for the five year period from 2007 to 2012."

- . . . or its independence . . .

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

- "Alix's methodologies for determining solvency were seriously flawed. That is, even if Alix had incorporated realistic projections of future performance into its analysis (it did not), Alix's solvency opinion still provides no basis for concluding that TOUSA was solvent on July 31. Among other failings, I find that Alix inappropriately used an EBITDA multiple in valuing the company."

- . . . or its methods.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

- "The Citi bankers on the deal should not have been surprised by these market challenges had they been paying attention. In that connection, I note that the lead Citi banker, Marni McManus, testified that it was not until Sunday, August 5, 2007—as a result of a call at her beach house from a Citi Colleague—that she first came to believe that the housing market downturn would be particularly severe."

- Lenders may even be required to foresee macroeconomic events.

DEFAULT MATERIALITY

Bank of America, N.A. v. 108 N. State Retail, LLC, 928 N.E.2d 42 (Ill. App. Ct. 2010)

Court affirmed appointment of receiver in foreclosure action because reasonable probability borrower's breach would be found material and lender would prevail on underlying foreclosure action.

- "The amount by which the loan was 'out of balance' exceeded $42 million on a loan with a maximum principal amount of $205,000,000. Such an amount, particularly in light of the fact that defendants have presented no evidence that they will be able to obtain the funds to put the loan back in balance, constitutes a material breach."

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Metro. Nat'l Bank v. Adelphi Academy, 23 Misc. 3d 1132A, 886 N.Y.S.2d 68 (Sup. Ct. Kings Co. 2009)

Bank's summary judgment motion denied based on borrower's failing to maintain level in interest reserve account because, as defendant never missed its monthly payments, default not material.

- "New York is in full keeping with the foregoing principles of law inasmuch as for a breach to be material it must be so substantial that it defeats the object of the parties in making the contract; the breach must go to the root of the agreement between the parties. "

Metro. Nat'l Bank v. Adelphi Academy, 23 Misc. 3d 1132A, 886 N.Y.S.2d 68 (Sup. Ct. Kings Co. 2009)

- "So too, while it is true that '[t]he law is clear that when a mortgagor defaults on loan payments, even if only for a day, a mortgagee may accelerate the loan, require that the balance be tendered or commence foreclosure proceedings, and equity will not intervene' the issue in the matter *sub judice* is whether there was ever any material breach, much less missed loan payments"

- "In light of the fact that Adelphi was meeting its primary financial obligations, however, it cannot be said that it was in material breach of the parties' basic agreement."

LENDER CONTROL OVER BORROWER'S OPERATIONS

FAMM Steel, Inc. v. Sovereign Bank, 571 F.3d 93 (1st Cir. 2009)

District Court of Massachusetts granted defendant's motion for summary judgment dismissing plaintiff's claims.

Facts

FAMM Steel was a steel fabricating company. Defendant Sovereign Bank loaned FAMM $6.1 million from 1998-2002. Edward Powers was the loan officer in charge of the account.

FAMM Steel, Inc. v. Sovereign Bank, 571 F.3d 93 (1st Cir. 2009)

In 2001, when FAMM suffered losses and FAMM's comptroller resigned, plaintiffs claimed bank forced it to hire consultant David Lee as comptroller for an interim period starting January 2002. Bank allegedly informed FAMM that Lee should approve his permanent replacement. After an interviewing process and Lee's approval, FAMM hired Woolford in March 2002, and at Sovereign's instructions, Lee trained Woolford. During 2002, Lee and Woolford mismanaged FAMM's accounts and presented FAMM with inaccurate financial data (both left the company by January 2003). FAMM was in covenant default by February 2002.

FAMM Steel, Inc. v. Sovereign Bank, 571 F.3d 93 (1st Cir. 2009)

Plaintiffs claimed that Sovereign's exacerbated the situation, including failing to issue a forbearance agreement or extending FAMM's line of credit, failing to allow FAMM to manage its account online and failing to respond to restructuring proposals.

Sovereign terminated FAMM's line of credit in May 2003 and sold FAMM's loans in March 2004 for $1.725 million, resulting in the facility being shut down and its assets being liquidated. Sovereign lost over $4 million.

In December 2006, plaintiffs filed suit against Sovereign alleging 12 claims, including liability under an instrumentality theory.

FAMM Steel, Inc. v. Sovereign Bank, 571 F.3d 93 (1st Cir. 2009)

Rule

A lender may be liable under a common-law instrumentality theory when the lender exerts such a degree of control over the borrower that the borrower becomes a mere business conduit for the lender.

Holding

The instrumentality theory did not apply because the lender's actions did not rise to the level of dominant control over the borrower.

FAMM Steel, Inc. v. Sovereign Bank, 571 F.3d 93 (1st Cir. 2009)

<u>Reasoning</u>

Instrumentality theory more applicable where third party creditor brings an action against a lender to recover for the debts of a borrower, akin to a piercing of the corporate veil theory. Even if the theory did apply here, Sovereign did not exercise such a degree of control:

- A creditor taking an active part in management is not by itself sufficient,

- No evidence that Sovereign directed Lee's actions,

- No evidence that Sovereign assumed actual, total control over FAMM's affairs (court noted this seemed unlikely considering FAMM suffered significant losses during Lee's term)

- The President and Vice President continued to serve throughout the relevant period.

FAMM Steel, Inc. v. Sovereign Bank, 571 F.3d 93 (1st Cir. 2009)

Other Relevant Findings

- Sovereign did not breach the covenant of good faith and fair dealing because none of the alleged bad acts of Sovereign were dishonest or purposefully done to injure FAMM and all acts occurred after FAMM was already in covenant default.

- Sovereign not liable for breach of fiduciary duty because no such relationship arose as no evidence plaintiffs reposed trust in Sovereign or that Sovereign accepted that trust. Sovereign did not exert a level of control over FAMM that was unusual in the commercial context or direct FAMM's day-to-day affairs; no evidence Lee acted under Sovereign's directions.

- Sovereign did not commit fraud because there was no evidence Sovereign knew Lee was not qualified or competent and nothing in the loan documents show that Power's statement that it was Sovereign's prerogative to have FAMM hire Lee was false.

IMPOSSIBILITY
COMMERCIAL IMPRACTIBILITY

Force Majeure

Allows a party to suspend or avoid performance when a supervising event beyond its control makes performance impossible. The event must not have been foreseeable at the time of contract, and generally the event must be shown to be a proximate cause of the failure to perform. Typical force majeure events might include Acts of God (such as natural disasters), riots, strikes, wars or government actions.

Commercial Impracticability

Restatement (2d) of Contracts, § 261: "Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or circumstances indicate the contrary."

Donald J. Trump v. Deutsche Bank Trust Co. Americas, No. 26841/2008 (N.Y. Queens Co.).

- Filed November 2008, Donald Trump sought an injunction postponing the maturity date of a $330 million loan for the construction of the Trump International Hotel and Tower in Chicago.

- Trump argued economic crisis is Force Majeure Event as defined in the loan agreement, and obligation to repay should be suspended until conditions improve because units in the building are not selling due to the economic crisis.

- Specifically, Trump argued the financial crisis falls within a broad catchall provision of the contract's definition of a Force Majeure Event: ". . . (xi) ***any other event or circumstance not within the reasonable control of Borrower or any Trade Contractor."***

- The force majeure issue was not adjudicated, as the case settled.

Donald J. Trump v. Deutsche Bank Trust Co. Americas, No. 26841/2008 (N.Y. Queens Co.).

Analysis

- While the current economic slump is very severe and beyond Trump's control, doubts that court would have found the economic crisis was unforeseeable or that performance is strictly impossible.

Bank of America, N.A. v. Shelbourne Dev. Grp., Inc., 2010 WL 3269647, No. 09-C-4963 (N.D. Ill. Aug. 18, 2010).

Background

- December 11, 2006 - Bank of America enters into a $3 million loan agreement with Shelbourne Development Group to develop the Spire Building in Chicago

- The loan agreement was amended in November 2008 and obligated Shelbourne to obtain a binding irrevocable construction loan commitment by November 1, 2008.

- Shelbourne failed to obtain a construction loan commitment

- Bank of America accelerated all amounts due under the notes and demanded full payment.

Bank of America, N.A. v. Shelbourne Dev. Grp., Inc., 2010 WL 3269647, No. 09-C-4963 (N.D. Ill. Aug. 18, 2010).

Commercial Impracticability Holding

- Shelbourne asserted the affirmative defense of commercial impracticability.

- Shelbourne alleged that its inability to perform was "(1) temporary, and (2) the result of an unforeseeable and unprecedented economic downturn and recession, particularly in the real estate market."

- Shelbourne supported these allegations by noting that bank's own executives repeatedly made statements describing the economic downturn as unprecedented, unparalleled, and not reasonably foreseeable.

Bank of America, N.A. v. Shelbourne Dev. Grp., Inc., 2010 WL 3269647, No. 09-C-4963 (N.D. Ill. Aug. 18, 2010).

- Viability of the defense depends upon whether the downturn was foreseeable because Shelbourne is presumed to have agreed to bear any loss that was foreseeable at the time of contracting.

- The court held that the foreseeability of the economic downturn could not be resolved by a motion to dismiss.

    - Court acknowledged that others may have foreseen the economic downturn, but that this case distinguishable based on Shelbourne's allegations that Bank's executives made public statements concerning the unforeseeability of the economic downturn.

    - Since Bank could not show with certainty that it would succeed on the affirmative defense, the motion to dismiss was denied.

UNFORCEABLE PENALTY

ING Real Estate Finance (USA) LLC v. Park Ave. Hotel Acquisition LLC, 26 Misc. 3d 1226(A), 2010 WL 653972 (Sup. Ct. N.Y. Co. Feb. 24, 2010)

Facts

- In April 2007, several lenders -- including Lehman Brothers Holding Inc. -- loaned $145 million to borrowers to finance the acquisition and development of 610 Lexington Avenue in Manhattan.

Master Credit Agreement:

- Loan "non-recourse," limited to the proceeds of the sale of the property through foreclosure, absent certain limited acts by the borrowers.

- In the event of a default, the lenders could bring a foreclosure action but could not seek deficiency judgment.

ING Real Estate Finance (USA) LLC v. Park Ave. Hotel Acquisition LLC, 26 Misc. 3d 1226(A), 2010 WL 653972 (Sup. Ct. N.Y. County Feb. 24, 2010)

- Under Guaranty, the guarantors undertook partial or full-recourse depending on triggers, as defined in the Credit Agreement. If full recourse, the guarantors and borrowers jointly and severally liable.

    - A full-recourse event occurred if borrowers incurred indebtedness beyond either the $145 million loan or other unsecured debt.

ING Real Estate Finance (USA) LLC v. Park Ave. Hotel Acquisition LLC, 26 Misc. 3d 1226(A), 2010 WL 653972 (Sup. Ct. N.Y. County Feb. 24, 2010)

Purported Breach and Consequences

- On April 14, 2009, the lenders sent a default notice.

- On June 16, 2009, brought foreclosure action based on claims that the borrowers had failed to pay the principal due on April 8, 2009.

- On July 14, 2009, the lenders filed an amended complaint to add the guarantors, alleging that the borrowers failed to pay $278,759.20 in real estate taxes triggering full-recourse.

- On July 20, 2009, the borrowers paid all real property taxes.

ING Real Estate Finance (USA) LLC v. Park Ave. Hotel Acquisition LLC, 26 Misc. 3d 1226(A), 2010 WL 653972 (Sup. Ct. N.Y. County Feb. 24, 2010)

Motion to Dismiss

- Court articulated issue: Whether -- by the terms of the credit agreement -- the nineteen-day tardiness in paying less than $300,000 in property taxes triggered a full-recourse obligation by the guarantors in an amount of up to $90 million (balance of the loan after accounting for the value of the property).

- Court relied on New York law under which it is impermissible for commercial agreements to be construed in a commercially unreasonable manner or in a way contrary to reasonable expectations of the parties. Here, the court determined that the parties did not intend -- nor would it be commercially reasonable -- for an interpretation of the Credit Agreement that would permit even a one-day delinquency to warrant full recourse.

- Court granted the motion to dismiss the full-recourse claims of the amended complaint.

ING Real Estate Finance (USA) LLC v. Park Ave. Hotel Acquisition LLC, 26 Misc. 3d 1226(A), 2010 WL 653972 (Sup. Ct. N.Y. County Feb. 24, 2010)

"Here, pursuant to section 9.3(d), plaintiffs would have moving defendants potentially liable for the entire debt of up to $145 million if the Borrower is just one day delinquent in paying a dollar in property taxes or any other debt for which a lien may be imposed. Such an unlikely outcome could not have been intended by the parties, sophisticated commercial borrowers and lenders aided by competent counsel at the time of the drafting and is impermissible under New York law (see Truck Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc., 41 N.Y.2d 420, 425 [1977] "(The rule is now well established. A contractual provision fixing damages in the event of breach will be sustained if the amount liquidated bears a reasonable proportion to the probable loss and the amount of actual loss is incapable or difficult of precise estimation. ***If, however, the amount fixed is plainly or grossly disproportionate to the probable loss, the provision calls for a penalty and will not be enforced)."***

PRELIMINARY INJUNCTION ENJOINING FUNDING SUSPENSION

Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

Background

- Construction funding for the Destiny USA mall in Syracuse, New York.

- Public-private partnership designed to showcase cutting-edge green technology and which offered the prospect of revitalizing Syracuse and Upstate New York.

Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

Loan Agreement:

- Syracuse Industrial Development Agency committed $170 million of bond funding.

- Citigroup's loan of $155 million as part of commitment to direct $50 billion toward combating global climate change.

- Destiny to invest $40 million in equity.

- Citigroup agent for all the construction proceeds (totaling $365 million), responsible for approving advances.

- Citigroup approved draw requests if certain conditions were met unless Citigroup determined the existence of a "Deficiency" where the project funds to be disbursed were less than the outstanding sums needed to complete.

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Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

Disagreement

- For the first 17 monthly fund disbursements, Citigroup released funds.

- With the 17th, 18th, and 19th draw requests, Citigroup alleged Deficiencies.

- Basis for "Deficiency" was that remaining sources were not sufficient to pay the remaining costs.

- Destiny disputed. Parties agreed to temporarily exclude tenant improvement costs from Deficiency calculations.

Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

- The 27th draw request was submitted in April 2009, with a funding due date of May 5, 2009.

- On May 20, 2009, Citigroup sent Deficiency notice, alleging that Destiny was deficient by over $15 million largely based on inclusion of tenant improvement costs in calculating the Deficiency.

- Destiny failed to cure the Deficiency within 10 business days, by depositing this amount, Citigroup declared default.

- Citigroup refused to fund the 28th and 29th draw requests.

- Destiny contended that the Project was 90% complete.

Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

Procedural History

- June 2009, Destiny filed suit and sought a preliminary injunction enjoining Citigroup from refusing to fund.
  - Preliminary injunction sought to require Citigroup to comply with the procedural requirements of the construction loan agreement when approving future loan advances – in particular, the contractually-mandated calculation of a Deficiency.
- July 17, 2009, Supreme Court, Onondaga County granted preliminary injunction. 2009 WL 2163483, 2009 N.Y. Slip Op. 51550(U) (Sup. Ct. Onondaga County 2009).
- On November 13, 2009, in a 3-2 decision, the Appellate Division affirmed. 69 A.D.3d 212, 889 N.Y.2d 793 (4th Dep't 2009).

Relevant Standards

To obtain a preliminary injunction, a plaintiff must show (1) a probability of success on the merits of an underlying action; (2) a danger of irreparable injury if an injunction is not issued; and (3) a balancing of the equities in the plaintiff's favor.

Trial Court Decision

- The trial court determined that Destiny would likely succeed on the merits of the claim that it was not in default. Citigroup was not entitled to stop funding.

  - The decision focused on the unambiguous language of the Loan Agreement, which ***did not include tenant improvement costs as part*** of the loan balancing equation but specifically stated that there may be work being performed for or by any tenants that is not being funded from the loan facility proceeds. Because there was no Deficiency under the Loan Agreement without considering tenant improvement costs, there was no default.

Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

- Acknowledged that a "mandatory injunction" ordering Citigroup to perform under the Loan Agreement was extraordinary. Nevertheless, the court determined that Destiny met the requirements:

  - **"Likelihood of success" - Court found clear and convincing evidence based on the unambiguous language in the Loan Agreement.**

  - **"Irreparable harm" - Court determined that, because of the unique nature of the project and the financial crisis, Destiny would not able to find a replacement loan and the project would be forced to shut down, with 90% complete.**

  - **"Balancing of the equities" - favored Destiny.**

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Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

Appellate Court Decision (3-2 Decision)

- The Appellate Division affirmed but narrowed holding:
  - Determined that Destiny had demonstrated a likelihood of success on the merits based on evidence that tenant improvement costs should not be included in Deficiency calculations.

Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

- The decision relied on two exceptions to the general rule that a preliminary injunction is not appropriate where purely monetary damages are available:

  - **Court took judicial notice of "the economic conditions that prevailed," in lieu of Destiny showing it could not obtain replacement financing.**

  - **Because of the unique "green economic" financing, for which there was apparently no precedent, it would be impossible to quantify damages.**

Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp.

Dissent

- No injunction because Destiny could borrow funds elsewhere and recover damages based on the higher cost of the replacement loan. Dissent disagreed with the characterization of the project as so exceptional as to warrant the holding affirmed by the court: "[W]hile the scope of the Project may be unique to the region in both its size and impact, the record clearly establishes that the Agreement itself is simply one to loan money in order to finance construction."

Subsequent Proceedings

- Citigroup has filed a motion for leave to appeal to the New York Court of Appeals which is pending.

Harlem Algonquin LLC v. Canadian Funding Corp., --- *F. Supp. 2d* ---, *2010 WL 3927698, at *3 (N.D. Ill. Oct 1, 2010).*

Northern District of Illinois rejected plaintiff's reliance on "two cases in which courts used preliminary injunctions to prevent defendants from terminating a plaintiff's line of credit," including Destiny and B.P. G. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp., 785 F. Supp. 222, 227-30 (D. Mass. 1991) (issuing a preliminary injunction requiring Chrysler to keep a line of credit open to a franchisee).

- Harlem Algonquin differentiated both Destiny USA Holdings and B.P. G. Autoland Jeep-Eagle, Inc. as cases about "pulling the plug on an ongoing business venture [which] differs greatly from refusing to fund the venture in the first place."

WAIVER AND ESTOPPEL

WAIVER

"Waiver is an intentional relinquishment of a known right." Gilbert Frank Corp. v. Fed. Ins. Co., 70 N.Y.2d 966, 968 (1988).

Brooklyn Fed. Saving Bank v. 9096 Meserole St. Realty LLC, No. 3012/10, 2010 N.Y. Misc. LEXIS 5450 (Kings Co. Nov. 5, 2010)

Facts

- Brooklyn Federal Savings Bank brought the suit to foreclose on mortgage.
- Borrower asserted that a Brooklyn Federal Savings Bank officer had orally represented that the bank would delay in declaring a default, and thus had "temporarily waived" the right to declare a default.
- Loan docs provided that no oral waivers effective.

Held Given no-oral-modification provision, the alleged oral waivers were insufficient.

<u>ESTOPPEL</u>

"[E]stoppel is an equitable doctrine; its purpose is to prevent wrong and injustice." ***<u>Sherman</u> v. <u>Town of Rhinebeck</u>*****, 133 A.D.2d 77, 79** N.Y. App. (2d Dep't 1987). Estoppel will be invoked "to prevent the infliction of unconscionable injury and loss upon one who has relied on the promise of another." <u>Am. Bartenders School, Inc</u>. v. <u>105 Madison Co</u>., 59 N.Y.2d 716, 718 (1983).

Nassau Trust Co. v. Montrose Concrete Prods., Corp., 56 N.Y.2d 175 (1982).

Facts

- Nassau Trust made a loan to Montrose Concrete, secured by a mortgage. Montrose Concrete failed to make payments. Instead of declaring a default, Nassau Trust agreed to an extension of the payment schedule.

- Montrose Concrete failed to meet extended payment schedule obligations, Nassau Trust declared a default and began foreclosure proceedings.

Nassau Trust Co. v. Montrose Concrete Prods., Corp., 56 N.Y.2d 175 (1982).

- Montrose Concrete alleged that Nassau Trust's officers orally represented that they would waive a default in payment under the extended schedule, to allow Montrose Concrete to sell its mortgaged property at fair market value (higher value than would be received in a foreclosure sale).

- Montrose Concrete provided a detailed description of its representatives' alleged conversations with Nassau Trust's officers, in which the officers allegedly told Montrose Concrete "not to lower [its] asking price" for the mortgaged property, and "not [to] worry about the terms of the letter [granting the extension of the payment schedule.]" Montrose Concrete alleged that it therefore continued to negotiate the sale of the property with potential purchasers in reliance upon those representations to obtain maximum value for the property.

Nassau Trust Co. v. Montrose Concrete Prods., Corp., 56 N.Y.2d 175 (1982).

<u>Held</u>

- Estoppel "rests upon the word or deed of one party upon which another rightfully relies and so relying changes his position to his injury."

- Montrose Concrete had alleged it reasonably relied upon the representations of Nassau Trust that no default would be declared, and that its reliance worked to its detriment in that "it continued to negotiate with [potential buyers of the mortgaged property] rather than seek other ways out of its dilemma." Therefore, its defense of estoppel provided sufficient factual questions to merit a trial and defeat the plaintiff's motion of summary judgment. The Court of Appeals accordingly remanded the case for trial.

Anglo Irish Bank Corp. v. Ashkenazy, No. 103006/10, 2010 N.Y. Misc. LEXIS 3784 (N.Y. Co. Aug. 4, 2010).

Facts

- Irish Bank asserted borrower defaulted by failing to pay the interest, and sought recovery from guarantors.

- In guarantee, guarantors waived defenses to the loan's validity such as equitable estoppel.

- The guarantors asserted equitable estoppel as a defense, alleging they were induced to sign the guarantee by bank's oral promise of additional line of credit to the borrower.

Anglo Irish Bank Corp. v. Ashkenazy, No. 103006/10, 2010 N.Y. Misc. LEXIS 3784 (N.Y. Co. Aug. 4, 2010).

Held

- To allow guarantors argument would be contrary to waiver of defenses in guarantee.

- Guarantors' reliance on bank's representations was foreclosed by the terms of guarantee, estoppel failed.

First Am. Title Ins., Co. of N.Y. v. Rubal, No. 018349-06, 2010 N.Y. Misc. LEXIS 1196 (Nassau Co. Jan. 22, 2010).

Facts

- First American's insured lender, Nations Credit, approved loan secured by already-encumbered property.

- First American and Nations Credit conducted a title search and concluded that the property was free of encumbrances. Nations Credit agreed to make a loan secured by a mortgage on the property.

- A senior lender foreclosed upon the property; Nations Credit received nothing as its interest in the property was extinguished. First American became subrogated to Nations Credit's interest in the loan, and commenced the suit against the borrower to recover the loan amount.

First Am. Title Ins., Co. of N.Y. v. Rubal, No. 018349-06, 2010 N.Y. Misc. LEXIS 1196 (Nassau Co. Jan. 22, 2010).

- Borrower alleged she believed the senior interests in the property had been extinguished prior to the loans made by Nations Credit. The borrower also alleged that she had contacted Nations Credit and First American to inquire about any encumbrances on the property and ask for assistance in litigating the suit by the more senior lender, but that Nations Credit and First American failed to respond.

- The borrower argued that, due to the Nations Credit's and First American's failure to discover and disclose the encumbrances on the mortgaged property or respond to her inquiries during the senior lender's foreclosure action, First American was estopped from now seeking payment of the amount of the loan.

First Am. Title Ins., Co. of N.Y. v. Rubal, No. 018349-06, 2010 N.Y. Misc. LEXIS 1196 (Nassau Co. Jan. 22, 2010).

Held

- A lender may be estopped from asserting rights under a mortgage to prevent fraud or injustice to a borrower who had detrimentally relied upon the lender's words or conduct. This doctrine may bar a suit by a lender where a borrower takes on additional debt in reliance upon the lender's representations that prior mortgages had been satisfied.

- Borrower had raised issues of fact on the defense of estoppel through her allegations that Nations Credit and First American had mistakenly informed her that the mortgaged property was free of encumbrances, and that she secured an additional loan in reliance upon their representations. Defense of promissory estoppel survived motion to dismiss.

MBIA Ins. Co. v. Royal Bank of Can., No. 12238/09, 2010 N.Y. Misc. LEXIS 3958 (Westchester Co. Aug. 19, 2010).

Facts

- MBIA and its subsidiaries allegedly entered into a credit default swap ("CDS") arrangement with RBC and its subsidiaries. The contracts at issue, however, were only signed by RBC, and not its subsidiaries.

- MBIA and its subsidiaries alleged that RBC and its subsidiaries misrepresented the quality of the collateral in the CDS arrangements, causing them to incur losses exceeding $145 million.

- MBIA argued that promissory estoppel required that the RBC subsidiaries be held liable for MBIA's losses, and "be estopped from claiming an excuse for the failure of those promises.

MBIA Ins. Co. v. Royal Bank of Can., No. 12238/09, 2010 N.Y. Misc. LEXIS 3958 (Westchester Co. Aug. 19, 2010).

Held

Because all of the contractual promises upon which MBIA and its subsidiaries allegedly relied originated with RBC, and not RBC's subsidiaries, the MBIA and their subsidiaries failed to allege a promise by the subsidiaries upon which they relied and their assertion of estoppel against the subsidiaries was thus dismissed.

PART 2:
LENDER LIABILITY CLAIMS IN BANKRUPTCY

Overview

- Recent Developments in Fraudulent Conveyance Law
- Equitable Subordination Risks
- Recharacterization of Debt as Equity
- Preferences

RECENT DEVELOPMENTS IN FRAUDULENT CONVEYANCE LAW

Fraudulent Conveyance Overview

The possibility that a transaction might be characterized as a fraudulent conveyance is probably the best known risk for secured lenders in bankruptcy (aside from simple undersecurity).

A transaction may be considered fraudulent if there is (a) actual fraud or (b) constructive fraud.

Actual fraud is found where a transaction was designed to frustrate a debtor's creditors.

In contrast, a transaction may be held to be constructively fraudulent if it is made while a debtor is insolvent or renders that debtor insolvent and was made for less than reasonably equivalent value.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

Lender Risk

- In TOUSA, the bankruptcy court for the Southern District of Florida breathed new life into the notion that fraudulent conveyance laws could be used to avoid debt and upstream guarantees in leveraged transactions.

- Given the state of modern corporate structures – in which it is relatively common for a group of subsidiaries to control the company's operating assets – and modern lending practices – under which security is generally demanded for significant loans – TOUSA raises the possibility that traditional security and loan structures may no longer be viable.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

Facts

• Prior to declaring bankruptcy, TOUSA was the fifth-largest homebuilder in the United States.

• Prepetition, TOUSA's operations, which occurred at the subsidiary level, were funded by a revolving credit facility.

• After one of its larger joint-ventures, Transeastern, encountered financial difficulties, the company entered into an amended and restated revolving credit agreement as well as a term loan credit facility in July 2007.

• Both credit facilities were secured by substantially all the assets of TOUSA, Inc. (the parent company) and various "Conveying Subsidiaries."

• Despite the attempted restructuring, TOUSA nonetheless filed for bankruptcy in January of 2008.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

<u>The Court's Findings</u>

• TOUSA and its subsidiaries were already insolvent before taking on the $500 million in secured loans.

• The lenders should have known that TOUSA was insolvent.

• The transaction left the conveying subsidiaries with unreasonably small capital.

➢ Although the loan agreements contained "savings clauses" designed to limit the guarantee exposure of the conveying subsidiaries and thus protect the loan from a fraudulent conveyance attack, such clauses are "entirely too cute to be enforced."

➢The conveying subsidiaries did not receive reasonably equivalent value for the liens that the new debt placed on its assets.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

What *TOUSA* means for subsidiary-collateralized financing:

There is something inherently distasteful about really clever lawyers overreaching. Some problems cannot be drafted around. The fact that this sort of drafting was felt necessary by Citi ought to have given it pause that maybe this deal was not possible. In any event, Citi and the rest of the Defendants assumed the risk that the Transaction would be regarded by a reviewing court as a fraudulent transfer.

TOUSA's rationale has not been adopted by other courts and the decision is currently on appeal.

While the decision may have been an aberration, it was without question intended as an attack on subsidiary-collateralized financing.

In re Tribune Co., Case No. 08-13141 (Bankr. D. Del. 2008)

Lender Risk

• The Tribune Co. bankruptcy, like TOUSA, highlights the fraudulent conveyance risks that lenders may face in highly leveraged transactions.

• Although there has not yet been (and may not be) a trial regarding the Tribune LBO, the bankruptcy examiner in that case filed an exhaustive report evaluating the claims against various parties involved in the transaction.

➢ Secured lenders in failed LBOs may face significant exposure.

➢ Failed LBOs may be regarded as actually fraudulent transfers.

In re Tribune Co., Case No. 08-13141 (Bankr. D. Del. 2008)

Facts

• In 2007, Tribune Company, one of the largest media companies in the country, was taken private in a leveraged buy-out that transferred ownership of the company to a newly-created employee stock ownership plan ("ESOP").

• The transaction was designed to occur in two steps, with new financing applying at each step. As part of the transaction, Tribune and its subsidiaries incurred obligations for funds that were used to cash out pre-transaction shareholders

• In total, approximately $8 billion in new debt was taken on to fund the transaction, bringing Tribune's total funded debt to approximately $13 billion.

• Following the completion of the transaction, Tribune was extremely leveraged and undertook asset sales as part of a post-transaction plan to de-lever.

In re Tribune Co., Case No. 08-13141 (Bankr. D. Del. 2008)

Facts (cont)

- Ultimately, Tribune was unable to sustain its debt load and filed for chapter 11 protection on December 8, 2008.

- The Committee of unsecured creditors undertook an investigation of the prepetition financings, and ultimately sought standing to bring certain claims.

- Ultimately, a bankruptcy examiner was appointed to evaluate various claims, including fraudulent conveyance claims against the prepetition lenders.

- After receiving extensive briefing from all parties, the examiner issued a report in which he evaluated the various claims and offered his predictions as to how a bankruptcy court would likely rule on those claims.

In re Tribune Co., Case No. 08-13141 (Bankr. D. Del. 2008)

<u>The Examiner's Findings</u>

- It was highly unlikely that the LBO lenders conveyed reasonably equivalent value with respect to funds used to cash out pre-transaction shareholders.

- Although it was highly likely that some value was conveyed with respect to funds used to pay the fees of the LBO lenders, the extent of that value (i.e., whether it was reasonably equivalent) was unclear.

- Although the question was close, it was somewhat <u>unlikely</u> that a court would include step two debt for purposes of determining step one solvency.

- It was reasonably unlikely that step one constituted an intentionally fraudulent transfer.

- It was somewhat likely that the second step of the LBO constituted an <u>intentionally</u> fraudulent transfer.

In re Tribune Co., Case No. 08-13141 (Bankr. D. Del. 2008))

What *Tribune* means for LBOs generally:

> Payments to stockholders to redeem stock are not transfers for which a debtor receives reasonably equivalent value because the debtor's stock is worthless to the debtor as a matter of law.[291] Thus, no value was conferred on any Tribune Entity for obligations incurred to the LBO Lenders to make these payments.

The essence of an LBO is having a company take on leverage to cash out shareholders. In declaring that a company cannot receive reasonably equivalent value for doing exactly that, the findings in the Tribune examiner's report, if adopted elsewhere, may make such transactions considerably more risky.

In re Tribune Co., Case No. 08-13141 (Bankr. D. Del. 2008))

What *Tribune* means for the fees of secured lenders:

> Case law at the circuit level does not provide specific guidance on how a court is to evaluate reasonably equivalent value in the context of obligations incurred to pay advisor or lender fees as part of a leveraged buyout transaction. Although the Third Circuit clearly requires that the court consider the actual value conferred by the transferee on the estate, it is uncertain what legal significance, if any, is attributed to the fact that the fees were incurred in connection with a leveraged buyout in which the debtor received less than reasonably equivalent value.

Where an LBO is found to be a fraudulent transfer, obligations incurred in order to pay lender fees may also be considered fraudulent.

In re Tribune Co., Case No. 08-13141 (Bankr. D. Del. 2008))

What *Tribune* means for two-step transactions:

The question actually is relatively close. As noted, the Examiner finds that at the time of Step One and in the days shortly following the Step One Financing Closing Date, it was highly likely that Step Two would happen. Tribune had procured comprehensive financing commitments for Step Two and, under the above-noted restrictive definition embodied in Company Material Adverse Effect, had limited the circumstances in which a decline in Tribune's performance alone could jeopardize funding or the Merger.

The Tribune examiner's report highlights a very real risk for secured lenders in multiple-step transactions that ramp-up leverage over time. There is a substantial possibility liabilities incurred in later stages of the transaction may be applied in a step one solvency analysis, thus placing a greater portion of the total obligation package at risk of avoidance.

In re Tribune Co., Case No. 08-13141 (Bankr. D. Del. 2008))

Primary risks highlighted by *Tribune*

The Examiner did not find any direct or "smoking gun" evidence that the Tribune Entities entered into the Step One Transactions with the intention to hinder, delay, or defraud creditors.

Although the Examiner found no direct evidence that this information was purposely withheld from the Tribune Board or Special Committee in December 2007,[179] the Examiner finds it difficult to accept that the failure to apprise the Tribune Board and Special Committee of this change to the Step One solvency valuation, and to the representation given by Tribune to VRC, was unintentional.[180]

Until Tribune, avoidance actions in LBO cases almost always proceeded as constructive fraudulent conveyance actions. In Tribune, however, the Examiner considered unrealistic growth expectations coupled with the failure to provide certain information to the Company's board as strong evidence of <u>intentional</u> fraud at step two.

In re Capmark Financial Group, 438 B.R. 471 (Bankr. D. Del. 2010)

Lender Risk

• Debtors in Chapter 11 cases have enormous leverage to settle estate causes of action, even over the dissent of prominent creditor groups.

• However, secured creditors may be able to use this leverage to their advantage by seeking pre-plan payment of debt if they are willing to make modest concessions – consider the time value of money.

In re Capmark Financial Group, 438 B.R. 471 (Bankr. D. Del. 2010)

Facts

• In March 23, 2006, a group of private equity investors acquired a 78% controlling interest in Capmark from its former parent, GMAC, for $1.5 billion.

•In connection with this transaction, Capmark refinanced existing debt with a $5.5 billion credit facility and a $5.25 billion bridge loan facility. In 2007, Capmark issued $2.55 billion in senior unsecured notes.

• After encounter severe financial distress in 2009, Capmark chose not to make an $855 million payment on bridge debt, despite having sufficient cash on hand. Instead, Capmark sought to restructure its debt and entered into negotiations with its creditors.

• On May 29, 2009 Capmark and certain of its existing bank creditors entered into a $1.5 billion term loan credit facility, secured by all of Capmark's U.S. and Canadian mortgage loan assets and foreclosed real estate and the proceeds of such assets.

In re Capmark Financial Group, 438 B.R. 471 (Bankr. D. Del. 2010)

Facts (cont)

• Although the Debtors spent the Summer and early Fall of 2009 attempting to negotiate a comprehensive restructuring with all of their creditors, they were ultimately unsuccessful and filed for chapter 11 protection in October of 2009.

• The official committee of unsecured creditors sought to bring avoidance actions against the secured lenders, and claimed that the secured credit facility amounted to an 11th-hour attempt to convert unsecured debt into secured debt.

•Nevertheless, the debtors and the secured lenders negotiated a settlement, whereby the secured lenders would receive prepayment (i.e., before confirmation of a plan of reorganization) on their debt at a 9% discount. The Debtors argued that such an arrangement was beneficial because it (a) provided for payment at a discounted rate and (b) relieved the estates of their obligation to pay interest on the debt at 4.5%.

•The committee of unsecured creditors objected.

In re Capmark Financial Group, 438 B.R. 471 (Bankr. D. Del. 2010)

The Court's Findings

• Entry into the secured credit facility temporarily averted a bankruptcy filing that would have been very detrimental to the company's going-concern value.

• Despite the committee's arguments to the contrary, the secured creditors were substantially oversecured.

• There is no per se rule against prepayment of prepetition claims through the settlement process.

• The committee's avoidance actions would be unlikely to succeed if allowed to proceed.

➢ The settlement was fair, equitable and should be approved.

In re Capmark Financial Group, 438 B.R. 471 (Bankr. D. Del. 2010)

What *Capmark* means for secured lenders:

> Accordingly, in weighing the Settlement against the Debtors' likelihood of prevailing against the secured lenders on a constructive fraudulent transfer charge, and taking into account the costs, risks, and uncertainty that would arise from denying the Settlement Motion in favor of pursuing litigation, the Court concludes the first prong of the *Martin* test weighs in favor of approving the Settlement.

9019 settlements that ultimately pay significant sums to secured creditors pre-confirmation may be approved over the objection of the unsecured creditors' committee if the debtors and the court can be brought onboard.

Consider using 9019 settlements aggressively to head off and resolve what could otherwise become lengthy and resource-intensive litigation for all parties involved.

Unsecured creditors with little to lose may try to "swing for the fences," but debtors and the court may be more reasonable.

In re Champion Enterprises Inc., *Case No. 10-50514*
2010 WL 3522132 (Bankr. D. Del. Sept. 1, 2010)

Lender Risk

• Lenders should be aware that section 544 of the bankruptcy code permits creditors to challenge transfers under state law fraudulent conveyance statutes, which may have different standards that transfers challenged under section 548.

In re Champion Enterprises Inc., Case No. 10-50514
2010 WL 3522132 (Bankr. D. Del. Sept. 1, 2010)

Facts

• Champion Enterprises manufactures pre-fabricated housing and modular buildings.

• With the decline of the construction market, its financial condition worsened and it entered into forbearance agreements with its lenders that improved the lenders' collateral position.

• Despite, the forbearance agreements, Champion ultimately filed for bankruptcy on November 15, 2009.

• Champion's official committee of unsecured creditors brought an action under New York State's fraudulent transfer statute, which is permissible in bankruptcy through section 544 of the bankruptcy code.

In re Champion Enterprises Inc., Case No. 10-50514
2010 WL 3522132 (Bankr. D. Del. Sept. 1, 2010)

The Court's Findings

• Rather than applying Delaware precedent, the court applied a New York State standard (which bankruptcy courts in the Southern District of New York also apply to fraudulent conveyance action brought under section 548).

• Per se rule: A debtor's grant of a security interest in its assets to a lender who has previously given the debt a cash loan may not be considered a fraudulent conveyance.

In re Champion Enterprises Inc., Case No. 10-50514
2010 WL 3522132 (Bankr. D. Del. Sept. 1, 2010)

What *Champion Enterprises* means for secured lenders:

> Likewise, the Complaint fails to sufficiently allege that the additional collateral provided to the Lending Group in connection with amendments to the Credit Agreement lacked fair consideration. These Transfers are security interests granted by Champion in respect of an antecedent debt and, like repayment of antecedent debt, they are necessarily fair consideration under the Fraudulent Conveyance Act.

Courts applying state law fraudulent transfer statutes may apply state standards that depart from federal bankruptcy practices.

Where courts apply the New York rule, past consideration is good consideration.

However, collateral enhancements may still be attacked as preferential.

EQUITABLE SUBORDINATION RISKS

Equitable Subordination Overview

Section 510(c) of the Bankruptcy Code permits a bankruptcy court to (a) equitably subordinate all or part of an allow claim to all or part of another allowed claim and (b) transfer any lien securing a subordinated claim to the estate.

Generally, equitable subordination is applied where a creditor has engaged in inequitable conduct that caused injury to other creditors or conferred an unfair advantage on the subject creditor.

Inequitable conduct includes: (a) causing a debtor to become undercapitalized, (b) engaging in fraud, (c) mismanaging a debtor entity and (d) breaching of a fiduciary duty owed to the debtor or other creditors.

In re Yellowstone Mountain Club, LLC, Case No. 08-61570-11 2009 WL 3094930 (Bankr. D. Mont., May 12, 2009)

Lender Risk

- Secured Lenders may face subordination of their claims and lien avoidance if they:
  - grossly fail to conduct proper due diligence, which results in
  - undercapitalization of the borrower.

In re Yellowstone Mountain Club, LLC, Case No. 08-61570-11 2009 WL 3094930 (Bankr. D. Mont., May 12, 2009)

Facts

• Case arose from a $375 million prepetition secured loan by Credit Suisse and other lenders to a real estate development near Big Sky, Montana.

•Up to $351 million was authorized by the credit agreement to be used for purposes outside of, and unrelated to, the Debtors' business.

• Previously, the Debtor's debt load had only ranged from approximately $4 to $60 million.

• In essence, the project developers took profits up front by mortgaging their project to the hilt.

• Credit Suisse received substantial fees for acting as agent for the loan.

In re Yellowstone Mountain Club, LLC, Case No. 08-61570-11 2009 WL 3094930 (Bankr. D. Mont., May 12, 2009)

The Court's Findings

- Credit Suisse's showed a lack of due diligence by:
  - failing to properly appraise the value of the mortgaged property; and
  - allowing 94% of the loan proceeds to be used for purposes unrelated to the borrow-developer's business purposes

- The $375 million in additional debt left the project company undercapitalized and was unreasonable in light of the company's prior debt load.

➢ As a result of these findings, the court subordinated Credit Suisse's $232 million share of the first-priority secured claim to the claims of the debtor-in-possession lender and the unsecured creditors.

In re Yellowstone Mountain Club, LLC, Case No. 08-61570-11 2009 WL 3094930 (Bankr. D. Mont., May 12, 2009)

What *Yellowstone* means for secured lenders:

> The naked greed in this case combined with Credit Suisse's complete disregard for the Debtors or any other person or entity who was subordinated to Credit Suisse's first lien position, shocks the conscience of this Court. While Credit Suisse's new loan product resulted in enormous fees to Credit Suisse in 2005, it resulted in financial ruin for several residential resort communities. Credit Suisse lined its pockets on the backs of unsecured creditors.

The reality is that not all courts like major financial institutions.

If a lender knows, or reasonably should know, that a deal will result in harm to unsecured creditors, equitable subordination may occur even where no fiduciary duty is owed to those unsecured creditors.

RECHARACTERIZATION OF DEBT AS EQUITY

Debt Recharacterization Overview

Unlike fraudulent transfer and equitable subordination risks, the possibility that a lender’s claims can be recharacterized as equity is not directly rooted in the text of the bankruptcy code.

Instead, the bankruptcy court’s power to recharacterize debt as equity stems from the court’s amorphous equity powers.

Until recently, there was some debate over whether recharacterization was still a viable tool; however, it is now clear that recharacterization is alive and well in most jurisdictions.

Recharacterization is typically applied when an insider loans money to an undercapitalized company rather than making a capital contribution.

In re Official Committee of Unsecured Creditors of Dornier Aviation (North America), Inc., 453 F.3d 225 (4th Cir. 2006)

Lender Risk

- If a lender's claim is recharacterized as equity it effectively becomes subordinated to all other claims. A recharacterized claim will share pari passu with other equity interests.

- This remedy differs from equitable subordination in two important respects:

  - First, an equitably subordinated claim is not necessarily subordinated to all other claims – the court may chose to limit subordination to a subset of other claims.

  - Second, by the terms of the bankruptcy code, a claim can only be subordinated to other claims, not to equity interests. As a result, an equitably subordinated claim will still (normally) collect ahead of all equity interests.

In re Official Committee of Unsecured Creditors of Dornier Aviation (North America), Inc., 453 F.3d 225 (4th Cir. 2006)

Facts

• Dornier Aviation (North America) ("DANA") was a wholly-owned subsidiary of Fairchild Dornier DMBH ("GMBH")

• GMBH shipped airplane parts to DANA with invoices that specified 30-day payment terms.

• In 2002, DANA was forced into involuntary bankruptcy, which it later converted to chapter 11.

• GMBH asserted a $146 million claim against DANA, for, among other things, back payments on the parts that it had shipped.

• Evidence was introduced that showed DANA was not expected to pay the invoices within 30 days. Instead, DANA was permitted to defer payment until its operation became profitable.

In re Official Committee of Unsecured Creditors of Dornier Aviation (North America), Inc., 453 F.3d 225 (4th Cir. 2006)

The Court's Findings

• The bankruptcy court rejected an argument raised by the official committee of unsecured creditors that GMBH's claim should be equitably subordinated, but instead recharacterized the approximately $86 million portion of GMBH's claim that was on account of the unpaid invoices as equity. This recharacterization put GMBH entirely out-of-the-money with respect to that $86 million claim.

• On appeal, the Fourth Circuit Court of Appeals ruled that bankruptcy courts retain the power to recharacterize debt as equity under section 105 and 726 of the bankruptcy code.

• The court observed that recharacterization and equitable subordination address different sorts of behavior: while equitable subordination is intended to address bad behavior by a creditor, recharacterization is intended to address the nature of the transaction itself.

In re Official Committee of Unsecured Creditors of Dornier Aviation (North America), Inc., 453 F.3d 225 (4th Cir. 2006)

The Court's Findings (cont)

- The court ruled that 11 factors should be considered when determining whether a claim should be recharacterized as equity:

1. names given to the instruments evidencing the indebtedness;
2. presence or absence of a fixed maturity date and schedule of payments;
3. presence or absence of a fixed rate of interest and interest payments;
4. source of repayments;
5. adequacy or inadequacy of capitalization;
6. identity of interest between creditor and stockholder;
7. the security, if any, for the advances;
8. borrower's ability to obtain financing from outside lending institutions;
9. whether the advances were subordinated to the claims of outside creditors;
10. extent to which the advances were used to acquire capital assets; and
11. presence or absence of a sinking fund to provide repayments.

In re Official Committee of Unsecured Creditors of Dornier Aviation (North America), Inc., 453 F.3d 225 (4th Cir. 2006)

What *Dornier Aviation* means for secured lenders:

A bankruptcy court's equitable powers have long included the ability to look beyond form to substance, *see Pepper v. Litton*, 308 U.S. 295, 305, 60 S.Ct. 238, 84 L.Ed. 281 (1939), and we believe that the exercise of this power to recharacterize is essential to the implementation of the Code's mandate that creditors have a higher priority in bankruptcy than those with an equity interest.

Although one of the factors considered (existence of security) automatically weighs in favor of secured creditors, they are <u>not</u> immune to recharacterization.

Transactions that would be rejected by arms-length creditors may be vulnerable to being recharacterized.

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PREFERENCES

Preference Overview

Under section 547 of the bankruptcy code, transfers made within 90 days prior to the petition date (or 1 year if made to an insider) are avoidable as preferential if the transfer:

- was to or for the benefit of a creditor;
- was on account of antecedent debt;
- was made while the debtor was insolvent;
- enables the creditor to receive more than such creditor would otherwise receive.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

Lender Risk

- New uncertainty as to:
  - the date on which a security interest in a tyax refund is acquire; and
  - the proper date for determining whether a lender is oversecured.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

Facts

• As part of the July, 2007 transaction previously discussed, TOUSA's secured lenders received security interests in all of the debtors' general intangibles, which were previously unencumbered.

•Due to substantial net operating loss carrybacks, TOUSA received a tax refund in excess of $200 million for 2007.

• Although the TOUSA filed for bankruptcy on January 28, 2008, the committee of unsecured creditors argued that the lenders' only acquired an interest in the tax refund on January 1, 2008.

• Moreover, the committee argued that a determination of whether the lenders were undersecured – and thus whether their additional security interest would have enhanced their recovery – need not be judged as of the petition date.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

The Court's Findings

- Where a security interest is granted in a net operating loss/tax refund context, interests are acquired as of the end of the tax year rather than as of the transaction date.

- The secured lenders could not rely on petition date schedules to determine their oversecurity. Instead, the bankruptcy court relied on a chapter 7 liquidation analysis conducted 8 months post-petition.

- TOUSA's grant of a security interest in its tax refunds was an avoidable preference.

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

What *TOUSA* means for preferences:

Because the debtors' schedules do not purport to estimate, and because they clearly overstate, the amount that could be obtained by the estates in a Chapter 7 proceeding, those schedules provide an unreliable answer to the question posed by Section 547(b)(5). By contrast, the Liquidation Analysis on which Plaintiff relies was prepared to address precisely the question that is relevant under Section 547(b)(5), namely, how much would the Debtors' estates recover if this were a Chapter 7 case. For that reason, the Liquidation Analysis provides a more reliable estimate of the answer to that question than do the schedules on which Citi would have me rely.

If the TOUSA decision is not overturned on appeal and is subsequently adopted more broadly, secured lenders will face an effective expansion of the preference window regarding security interests in tax refunds.

More important, TOUSA threatens to inject uncertainty into the question of the proper reference date for determining oversecurity.

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CONCLUDING REMARKS

PART 3:
QUESTIONS